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January 14, 2004

Ms. Emma Karlen
Finance Director
City of Milpitas
455 East Calaveras Boulevard
Milpitas, CA 95035

Dear Emma:

We are pleased to confirm our understanding of the services we are to provide for the City of Milpitas for the year ended June 30, 2004. The services we have been engaged to provide are outlined below, but we are also available to provide accounting and consulting services at your request:

- 1) Audit of the basic financial statements, preparation of memorandum on internal controls, review of appropriations limit report and assistance with the preparation of the Comprehensive Annual Financial Report.
- 2) Audit of the Redevelopment Agency financial statements and tests of compliance.
- 3) Test two Single Audit Act programs for compliance.
- 4) Test Transportation Development Act program for compliance.
- 5) Audit of the financial statements of the Milpitas Public Financing Authority.
- 6) Tests of the State/Local Partnership Program compliance.
- 7) Series 2003 Tax Allocation Bonds – review the footnote disclosure and the City-prepared journal entries.

We understand that financial statements will be presented in accordance with the financial reporting model described in GASB Statement No. 34.

Audit Objective

The objective of our audit is to express an opinion on whether your basic financial statements are fairly presented in all material respects in conformity with generally accepted accounting principles in the United States of America and to report on the fairness of accompanying supplemental information when considered in relation to the basic financial statements taken as a whole. The objective also includes reporting on:

- Internal controls related to the financial statements and compliance with laws, regulations, and the provisions of contracts or grant agreements, noncompliance with which could have a material effect on the financial statements in accordance with *Government Auditing Standards*.
- Internal controls related to major programs and an opinion (or disclaimer of opinion) on compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on each major program in accordance with the Single Audit Act Amendments of 1996 and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

The reports on internal control and compliance will each include a statement that the report is intended for the information and use of the Council or their appointed committee, management, specific legislative or regulatory bodies, federal awarding agencies, and if applicable, pass-through entities.

Our audit will be conducted in accordance with generally accepted auditing standards in the United States of America; the standards for financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; the Single Audit Act Amendments of 1996; and the provision of OMB Circular A-133, and will include tests of accounting records, a determination of major programs in accordance with Circular A-133 and other procedures we consider necessary to enable us to express such an opinion and to render the required reports. If our opinion on the basic financial statements or the Single Audit compliance opinion is other than unqualified, we will fully discuss the reasons with you in advance. If, for any reason, we are unable to complete the audit or are unable to form or have not formed an opinion, we may decline to express an opinion or to issue a report as a result of this engagement.

Management Responsibilities

Management is responsible for establishing and maintaining internal control and for compliance with the provisions of contracts, agreements, and grants. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of the controls. The objectives of internal control are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, that transactions are executed in accordance with management's authorizations and recorded properly to permit the preparation of basic financial statements in accordance with generally accepted accounting principles, and that federal award programs are managed in compliance with applicable laws and regulations and the provisions of contracts and grant agreements.

Management is responsible for making all financial records and related information available to us. We understand that you will provide us with the Closing Checklist information required for our audit and that is responsible for the accuracy and completeness of that information. We will advise you about appropriate accounting principles and their application and will assist in the preparation of the financial statements, including the Schedule of Expenditure of Federal Awards, but the responsibility for the financial statements remains with you. This responsibility includes the establishment and maintenance of adequate records and effective internal control over financial reporting and compliance, the selection and application of accounting principles and the safeguarding of assets. Management is responsible for adjusting the financial statements to correct material misstatements and for confirming to us in the representation letter that the effects of any uncorrected misstatements aggregated by us during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statement taken as a whole. You are responsible for the design and implementation of programs and controls to prevent and detect fraud, and for informing us about all known or suspected fraud affecting the government involving (a) management, (b) employees who have significant roles in internal control, and (c) others where the fraud could have a material effect on the financial statements. You are also responsible for informing us of your knowledge of any allegations of fraud or suspected fraud affecting the government received in communications from employees, former employees, regulators, or others. In addition, you are responsible for identifying and ensuring that the entity complies with applicable laws and regulations. Additionally, as required by OMB Circular A-133, it is management's responsibility to follow up and take corrective action on reported audit findings and to prepare a summary schedule of prior audit findings and a corrective action plan. The summary schedule of prior audit findings must be made available for our review.

Audit Procedures - General

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; therefore, our audit will involve judgment about the number of transactions to be examined and the areas to be tested. Also, we will plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether from errors, fraudulent financial reporting, misappropriation of assets, or violations of laws or governmental regulations that are attributable to the entity or to acts by management or employees acting on behalf of the entity. As required by the Single Audit Act Amendments of 1996 and OMB Circular A-133, our audit will include tests of transactions related to major federal award programs for compliance with applicable laws and regulations and the provisions of contracts and grant agreements. Because of the concept of reasonable assurance and because we will not perform a detailed examination of all transactions, there is a risk that material errors, noncompliance, fraud or other illegal acts, may exist and not be detected by us. In addition, an audit is not designed to detect immaterial misstatements, immaterial illegal acts, or illegal acts that do not have a direct effect on the financial statements or major programs. We will advise management of any material errors and any fraudulent financial reporting or misappropriation of assets that comes to our attention. We will also inform the management of any violations of laws or governmental regulations that come to our attention, unless clearly inconsequential. We will include such matters in the reports required for a Single Audit. Our responsibility as auditors is limited to the period covered by our audit and does not extend to matters that might arise during any later periods for which we are not engaged as auditors.

Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts, and may include direct confirmation with selected individuals, creditors and banks. We will request written representations from your attorneys as part of the engagement, and they may bill you for responding to this inquiry. At the conclusion of our audit we will also request certain written representations from you about the financial statements and related matters.

Audit Procedures - Compliance

Our audit will be conducted in accordance with the standards referred to in the section titled Audit Objectives. As part of obtaining reasonable assurance about whether the basic financial statements are free of material misstatement, we will perform tests of the City's compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit will not be to provide an opinion on overall compliance and we will not express such an opinion in our report on compliance issued pursuant to *Government Auditing Standards*.

OMB Circular A-133 requires that we also plan and perform the audit to obtain reasonable assurance about whether the City has complied with applicable laws and regulations and the provisions of contracts and grant agreements applicable to major programs. Our procedures will consist of the applicable procedures described in the *OMB Circular A-133 Compliance Supplement* for the types of compliance requirements that could have a direct and material effect on each major programs. The purpose of those procedures will be to express an opinion on the City's compliance with requirements applicable to major programs in our report on compliance issued pursuant to OMB Circular A-133.

Audit Procedures - Internal Controls

In planning and performing our audit we will consider the adequacy of internal controls in determining the nature, timing and extent of our auditing procedures applied for the purpose of expressing an opinion on the basic financial statements and on its compliance with requirements applicable to major programs.

We will obtain an understanding of the design of the relevant controls and whether they have been placed in operation, and we will assess control risk. Tests of controls may be performed to test the effectiveness of certain controls that we consider relevant to preventing and detecting errors and fraud that are material to the basic financial statements and to preventing and detecting misstatements resulting from illegal acts and other noncompliance matters that have a direct and material effect on the basic financial statements. Tests of controls relative to the basic financial statements are required only if control risk is assessed below the maximum level. Our tests, if performed, will be less in scope than would be necessary to render an opinion on internal control and, accordingly, no opinion will be expressed in our report on internal control issued pursuant to *Government Auditing Standards*.

As required by OMB Circular A-133, we will perform tests of controls to evaluate the effectiveness of the design and operation of controls that we consider relevant to preventing or detecting material noncompliance with compliance requirements applicable to each major program. However, our tests will be less in scope than would be necessary to render an opinion on those controls, and accordingly, no opinion will be expressed in our report on internal control issued pursuant to OMB Circular A-133.

Our audit is not designed to provide assurance on internal control or to identify reportable conditions. However, we will inform the Council or their appointed committee of any matters involving internal control and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal controls that in our judgment could adversely affect the City's ability to record, process, summarize and report financial data consistent with the assertions of management in the basic financial statements. We will inform you of any nonreportable conditions or other matters involving internal control, if any, as required by OMB Circular A-133.

Fees

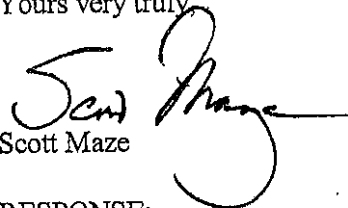
Our fees for these services are billed based on our contract with you, which in turn is based on the actual time expected to be spent at our standard hourly rates, including travel and other out-of-pocket costs such as report production, typing, postage, etc. Our standard hourly rates vary according to the degree of responsibility involved and the experience level of the personnel assigned to your audit. Our invoices for these fees will be rendered each month as work progresses and are payable on presentation. In accordance with our firm policies, work may be suspended if your account becomes thirty days or more overdue and may not be resumed until your account is paid in full.

These fees are based on anticipated cooperation from your personnel, the completion of schedules and data requested on our Closing Checklist, and the assumption that there will be no unexpected increases in work scope, such as new Single Audit Act programs, new debt issues, etc., or delays which are beyond our control, as discussed on the Fees Attachment to this letter. If significant additional time is necessary, we will discuss it with you and arrive at a new fee before we incur any additional costs.

Government Auditing Standards require that we provide you with a copy of our most recent quality control review report. Our 2002 peer review report accompanies this letter.

We appreciate the opportunity to be of service to the City and believe this letter accurately summarizes the significant terms of our engagement. If you have any questions, please let us know. If you agree with the terms of our engagement as described in this letter, please sign the enclosed copy and return it to us.

Yours very truly,


Scott Maze

RESPONSE:

This letter correctly sets forth the understanding of the City of Milpitas.

By: _____

Title: _____

Date: _____

**City of Milpitas Engagement Letter
Fees Attachment**

Our fees for the work described in the attached engagement letter will be as follows, unless they are adjusted for one or more of the items below:

Item	Fee
CAFR/Prop 111/Management Letter	\$57,627
Redevelopment Agency	8,617
Single Audit, 2 programs	10,467
Transportation Development Act (one project)	2,230
Public Financing Authority	3,601
State/Local Partnership Program	2,817
Series 2003 Tax Allocation Bonds – review journal entries and footnote disclosure	1,500
	<u>\$86,859</u>

2004 Fees - Our recurring fees have been adjusted only for the change in the services component of the Bay Area Cost of Living Index for the San Francisco Bay Area (1.4%). The fees above include GASB 34 audit costs, which have been detailed separately in the enclosed schedule.

Additional Services - The above fees are for audit and assurance services described in the accompanying engagement letter. They do not include fees for assisting with closing the books nor providing other accounting services. Should the City require assistance beyond audit services we have included a separate Fees for Accounting Services list of services that we have provided to our clients.

Services Prohibited by the GAO - New independence rules issued by the Governmental Accounting Office prohibit auditors from performing certain services. We have provided a schedule of Tasks Prohibited Under the GAO Independence Rules which lists the most frequently occurring types of services we are no longer allowed to provide to the City.

Report Finalization - Our fee is based on our understanding that all information and materials necessary to finalize all our reports will be provided to us before we complete our year-end fieldwork in your offices. In the case of CAFRs, this includes all the materials and information required to print the CAFR. As in the past, we will provide final drafts of all our reports before we leave your offices. We will schedule a Final Changes Meeting with you for a date no more than two weeks after we complete our fieldwork. At that meeting, we will finalize all reports for printing. After that date, report changes you make and changes required because information was not received timely will be billed at our normal hourly rates.

Post-Closing Client Adjusting Entries - The first step in our year-end audit is the preparation of financial statement drafts from your final closing trial balance. That means any entries you make after handing us your closing trial balance must be handled as audit adjustments, or in extreme cases, by re-inputting the entire trial balance, even if the amounts are immaterial. If you make such entries and the amounts are in fact immaterial, we will bill you for the costs of the adjustments or re-input at our normal hourly rates.

Recurring Audit Adjustments - Each year we include the prior year's adjusting entries as new steps in our Closing Checklist, so that you can incorporate these entries in your closing. If we are required to continue to make these same adjustments as part of this year's audit, we will bill for this service at our normal hourly rates.

CAFR Printing - As a convenience, we can send your CAFR to a printer we use locally. We do not charge for delivering camera-ready print masters to any printer of your choice and delivering the CAFRs or GPFS to you. However, we will bill you for any additional time spent on the CAFR printing at our normal hourly rates. This includes changes after the report goes to the printer, obtaining, reviewing and / or delivering printer's proofs, etc.

We can also help with CAFR design, including covers, tabs, dividers, color choices, bindings, organization, charts, maps, etc. We will estimate these costs for you before proceeding.

Single Audit Act - Additional programs will cost \$5,234 each, unless there are other factors which add to that program's cost; in that case, we will provide a cost estimate before proceeding.

Grant Programs Requiring Separate Audit - Grant programs requiring separate audits represent a significant increase in work scope, and fees for these audits vary based on the grant requirements. If you wish us to determine and identify which programs are subject to audit, we will bill you for that time at our normal hourly rates.

Changes in City Personnel - Our experience is that changes and /or reductions in Finance Department staff can have a pronounced impact on costs of performing the audit. If such changes occur, we will meet with you to assess their impact and arrive at a new fee before we begin the next phase of our work. However, we reserve the right to revisit this subject at the conclusion of the audit, based on your actual performance and our actual costs.